B. RECENT DEVELOPMENTS IN HOUSING REGARDING QUALIFICATION STANDARDS AND PARTNERSHIP ISSUES

by
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The first part of this article provides an update of exemption standards under IRC 501(c)(3) for housing organizations. The update chiefly discusses a proposed revenue procedure, Announcement 95-37, 1995-20, I.R.B. 18, that lists general exemption qualification standards for housing organizations under IRC 501(c)(3) and a safe harbor and facts and circumstances for low-income housing groups seeking tax-exempt status. The safe harbor and facts and circumstances generally take into account a shift in the national housing policy away from large public housing projects to housing with lower concentrations of poor residents. The proposed revenue procedure also makes clear that housing organizations may qualify for tax-exempt status under alternative charitable purposes.

The second part of the article discusses organizations that seek to provide charitable housing as a general partner in a limited partnership. The use of limited partnerships is becoming an extremely popular device for funding low-income housing projects, driven by the drying up of public funds for housing and the economics that encourage private investors to invest in low-income housing projects qualifying for tax credits under IRC 42. This is an important source of funding with $300 million in credits available for allocation annually. This discussion is particularly timely for the key district offices since the standards for referral of exemption applications under IRM 7664.31(12) were changed by Manual Transmittal 7600-100 (November 10, 1994) to now require referral to Headquarters of exemption applications involving partnerships, but only when the partnerships will involve health care organizations.

PART I - Qualification Under Announcement 95-37

1. Background

Articles on housing appeared in 1992 and 1994 EO CPE texts. This discussion updates and supplements those discussions.

Housing organizations may qualify for tax-exempt status under IRC 501(c)(3) if they satisfy charitable purposes which include relief of the poor and distressed or elderly, lessening neighborhood tensions, eliminating prejudice and discrimination, combatting community deterioration or lessening the burdens of government.

On October 16, 1992, the Internal Revenue Service published the Safe Harbor Guideline for Low Income Housing in IRM 7664.34. The intent of the guideline was to provide a bright-line standard for key district referral to Headquarters of applications from housing organizations seeking to qualify for tax exempt status under IRC 501(c)(3) because they "relieve the poor and distressed," as that term is used in Reg. 1.501(c)(3)-1(d)(2). To assure adequate public notification, the Service reprinted the Guideline in Notice 93-1, 1993-1 C.B. 290. This notice provided some additional explanation and requested public comment.

Generally, an organization will meet the safe harbor guideline under Notice 93-1 if it establishes that at least 75 percent of the units for a given project will be made available for families earning 60 percent or less of the area's median income, as adjusted for family size. Of the remaining 25 percent of the units, if any, the organization must adopt a general policy that states the remaining units will be made available to persons on the lower end of the economic spectrum who may not necessarily be members of a charitable class.

Many comments were critical of the standard as being too restrictive. They argued that the guideline is contrary to national housing goals favoring deconcentration, that it is contrary to qualification standards of other housing provisions in the Code, that it is contrary to what they perceived as the Service's long-standing use of 80 percent of the area's median income as a charity standard demonstrating poor and distressed, that it is contrary to existing housing programs, and that it preempted application of other charitable purposes.

2. Announcement 95-37

On May 15, 1995, Announcement 95-37 was published in 1995-20 I.R.B. 18. The announcement with its proposed revenue procedure has three objectives. First, it sets forth a revised safe harbor that provides a bright line for exemption of organizations providing housing to the poor. Second, the announcement sets forth specific facts and circumstances that may be used to demonstrate the relief of the poor and distressed in lieu of the safe harbor. Third, the announcement outlines the charitable purposes that may be carried out by housing organizations aside from relief of the poor and distressed.

A. Safe Harbor Requirements

The announcement provides that an organization will satisfy the safe harbor if (1) at least 75 percent of the units are occupied by families that qualify as low-income (80 percent of the area's median income); and (2) at least 20 percent of the units are occupied by residents that are very low-income (50 percent of the area's median income) or that 40 percent of the units are occupied by residents whose incomes do not exceed 120 percent of the area's very low-income limit (60 percent of the area's median income).

Generally, the announcement addresses concerns regarding the restrictive standard of the notice and that the Service may not be in step with federal housing goals to decrease large concentrations of very poor residents. The announcement recognizes that stability within a project is important to the achievement of charitable housing programs. Housing without stability may fail to provide safe, decent and sanitary housing affordable to the poor and lead to the premature dislocation of the intended beneficiaries.

The announcement specifically requires actual occupancy by qualifying residents whereas the notice specified that the units must be made available to the qualifying residents. In addition, the notice did not require rent restrictions whereas the announcement considers rent restrictions critical to a demonstration of relief of the poor and distressed.

An example of the application of the safe harbor for a one hundred unit project is as follows, assuming 25 percent of the units are occupied by nonqualifying residents paying market rate:

(1) The 75 remaining qualifying units are comprised of 20 very low-income units (50 percent of the area's median income) and 55 low-income units (80 percent of the area

is median income); or

(2) The 75 remaining qualifying units are comprised of 40 units rented at 120 percent of the very low-income limit (60 percent of the area's median income) and 35 low-income units (80 percent of the area's median income).

B. Other Provisions

Notice 93-1 adopted the use of the area median income set forth in the HUD Income Limits for Low and Very Low-Income Families, but it did not incorporate the adjustments that HUD applies to the low and very-low income limits. HUD makes adjustments for low-income areas, high housing cost areas, and low housing cost areas. HUD also provides a cap for high-income areas. These adjustments are included in the tables of income limits adjusted for family size. Adoption of median income figures without use of the tables of income limits is inconsistent with Service use of the HUD income limits in similar contexts. Rev. Rul. 89-24, 1989-1 C.B. 24, notes Service adoption of standards consistent with low and median income determinations under the United States Housing Act of 1937 for purposes of qualified residential rental projects tax-exempt bonds under IRC 142 and low-income housing tax credits under IRC 42. Use of the HUD tables of income limits with adjustments for family size and area income and cost variations is consistent with the purposes of the safe harbor guideline's intent to establish a bright line for determining whether individuals are unable to afford safe and decent housing without undue hardship. Accordingly, the safe harbor is revised to incorporate use of the HUD income limits including its adjustments and caps.

To assure that the safe harbor uses the adjustments made by HUD, the announcement sets income levels by reference to "low-income" and "very low-income" as those terms are defined under the United States Housing Act of 1937. Use of these terms accommodates concerns that the safe harbor would not allow for incorporation of allowances for economic difference in housing costs by area and adjustments for family size if only the median income were used. To assure that organizations use the HUD tables rather than merely refer to the median income figure, the announcement requires use of 120 percent of very low-income rather than 60 percent of the median income. It assumes that organizations will use the tables to adjust for family size.

The safe harbor permits occupancy of up to 25 percent of the units by non-charitable class residents. Their presence is considered to support the exempt purpose of the organization because of the social and economic integration they provide to a project. Notice 93-1 requires these residents to be at the lower end of the economic spectrum. This language was borrowed from variances permitted by HUD under section 8 of the United States Housing Act of 1937 and other public housing programs. This is, in effect, a variance allowed because it is incidental to the housing purpose of the organization. From this perspective it makes sense to limit the participants to lower economic levels. However, the non-charitable class residents are not considered as an incidental amount of non-qualifying residents under the safe harbor guideline. Their presence assists charitable goals. They allow greater deconcentration of the poor, thus assuring a greater opportunity for a project to achieve its purpose. They also allow for the social and economic integration of the poorer residents. Accordingly, limiting these residents to the lower economic spectrum serves no charitable purpose. Therefore, the safe harbor is revised to allow any income levels in the non-charitable class residents.

Under Notice 93-1, 75 percent of the units would have been required to be "made available" for families at 60 percent or less of the area's median income. Although the safe harbor may have been unclear in its use of the term "made available," use of the term has consistently required actual occupancy. The charitable purpose under the safe harbor is not satisfied by the mere potential for the relief of the poor and distressed. An organization must actually relieve the poor and distressed through actual occupancy. Accordingly, the announcement provides for revision of the safe harbor to require that an organization have a purpose to actually relieve the poor and distressed.

Some have indicated a concern that an actual occupancy requirement could cause a project to lose its exemption causing bonds issued under IRC 145 to fail. Organizations developing new projects may qualify for exemption before they have the ability to benefit a charitable class during a reasonable period of time that it takes to develop and construct the project. Similarly, if the organization purchases an existing facility, the announcement does not require the organization to immediately benefit a charitable class because an organization may acquire a development subject to the rights of the existing residents. So long as the organization operates in a manner to remove the non-qualifying residents as rapidly as feasible and fill the vacant units with qualifying residents, the operation of the facility during a one-year transition period (or longer if operated under a government program allowing a longer period) is considered as reasonable to carry out the exempt purpose. A project's short-lived operation prior to complying

with the safe harbor is considered reasonably related to achieving as exempt function. Any delays beyond the shortest period of time required to make the transition would indicate that the facility is operated for a nonexempt purpose.

Although some suggest that the safe harbor should be applied on a program-wide basis, the safe harbor may only be applied in a manner that assures that the non-charitable class members have contact with the charitable class members. To allow satisfaction of the percentages on a program-wide basis subverts the purpose of the non-charitable class residents and would permit projects in which none of the residents are members of a charitable class. Therefore, the safe harbor is applied on a project-wide basis.

Notice 93-1 provided that qualifying residents may be made up of a composite including poor, elderly and handicapped residents. This composite was intended to avoid the situation where other clearly charitable beneficiaries are precluded from a low-income housing project because they are not poor. However, the composite used to attain 75 percent charitable class residents has resulted in confusion in the application of elderly and handicapped housing standards established pursuant to Rev. Rul. 72-124, 1972-1 C.B. 145, Rev. Rul. 79-18, 1979-1 C.B 194, and Rev. Rul. 79-19, 1979-1 C.B 195. It could permit the qualification for exemption under the safe harbor of an elderly housing project which does not provide for the needs of the elderly and in which a significant number of the residents were elderly but not poor. This is not the purpose of the safe harbor and a composite charitable class will not be used to establish the composition of qualifying residents.

Notice 93-1 did not address whether rents charged charitable class residents need to be restricted to assure that the units will be affordable. Rev. Rul. 70-585, 1970-2 C.B. 115, at Situation 1, states that the organization accomplishes a charitable purpose by providing homes to low-income families determined to be poor and distressed who could not otherwise afford them. Absence of a rent restriction could lead to the qualification of organizations housing poor and distressed persons at rates that are not affordable. This would not relieve their distress. An organization may demonstrate that its housing is affordable through compliance with government or other reasonable rent restrictions that relieve the poor and distressed. A restriction at a level of 30 percent of a resident's income would demonstrate affordable housing. The announcement revises the safe harbor to require rent restrictions to assure relief of the poor and distressed.

Many federal housing programs permit residents admitted with qualifying

income levels to be retained even if the residents' incomes rise above qualifying income limitations. The safe harbor is revised to be consistent with these other programs by addressing the situation where a project initially satisfies the safe harbor income limitations but subsequently fails to satisfy these limitations because of increases in residents' income levels. Provided that a resident's income does not exceed 140 percent of the qualifying limit, the resident will continue to be treated as a qualifying resident. If a resident's income exceeds 140 percent of the qualifying limit, that resident will no longer be treated as a qualifying resident. However, the project will continue to qualify under the safe harbor provided that the next available comparable nonqualifying unit is rented to someone under the qualifying limits.

The announcement liberalizes the numerical safe harbor requirements to allow for exemption of organizations financing projects with proceeds from bonds issued pursuant to IRC 145. However, the liberalized requirements did not accept use of an IRC 142 set-aside as a charity standard as is often argued by organizations using this type of financing. That is, merely demonstrating that 20 percent of the residents have incomes at or below 50 percent of the area's median income or that 40 percent of the residents have incomes at or below 60 percent of the area's median income will not demonstrate a charitable purpose.

Under IRC 145(a) an organization must first qualify as charitable under IRC 501(c)(3) before satisfying any set-aside requirements. However, some argue that it is absurd to apply an IRC 142 set-aside if the charity requirements are already more restrictive. The implication of the set-aside is that the charity requirements are less restrictive. However, H.R. Rep. No. 795, 100th Cong. 2d Sess. 585, indicates that the amendment applying the set-aside to charities is an anti-abuse provision meant to prevent for-profit developers from using captive exempt organizations to finance rental housing and avoid the set-aside requirements of IRC 142. The report notes further that developers would often churn "burned-out" tax shelters with the current developers as project operators under management contracts producing similar returns. Because these captive exempt organizations had no charitable purpose and because no one was watching the store at the time prior to the amendment, there was a need for Congress to impose a set-aside requirement for financing existing facilities under IRC 145(d)(2) to remove the incentive of for-profit developers from using IRC 145. Thus, it is not inconsistent to have a charity requirement that is more restrictive than the set-aside.

In addition, Congress rejected an opportunity to add the set-aside requirement to new housing projects or existing housing projects receiving

substantial rehabilitation. This is fully consistent with the reasons for adding the set-aside requirement of IRC 142 only to existing housing projects under IRC 145(d)(2). The abuse occurred primarily in the churning of existing projects.

Finally, the IRC 142 set-aside requirements are the same for IRC 42 tax credits and apply equally to for-profit or tax-exempt organizations under IRC 501(c)(3). Accordingly, the set-aside is not meant to distinguish a for-profit from a charitable organization.

3. Facts and Circumstances

A. History

Discussions provided in GCM 35007 (August 8, 1972) and GCM 36293 (May 30, 1975) note that the term "poor and distressed" means the inability to afford the necessities of life without undue hardship. While poverty may be easily recognizable at the very lowest end, the line separating poverty from moderate income is not so clear. Because of the difficulty in isolating facts and circumstances that should apply in defining poor and distressed, they never really developed.

Other discussions provided in GCM 33671 (October 30, 1967), GCM 33672 (October 30, 1967) and GCM 36293 note that participation in a government housing program does not in itself establish qualification for exemption under IRC 501(c)(3). These GCMs concluded that participation in either a federal government section 221(d)(3) program (12 U.S.C. 1715l) available to families at 95 percent or less of the median income or a section 236 program (12 U.S.C. 1715z) available to families at 80 percent or less of the median income did not constitute an exclusively charitable purpose. This is also concluded in Rev. Rul. 70-585 (Situation 4), in which housing funded under a federal program was not considered as charitable. Essentially, the Service rejects a conclusion that participation in a government housing program at 80 percent or less of median income demonstrates poor and distressed under Reg. 1.501(c)(3)-1(d)(2).

The Service position regarding the provision of housing to relieve the poor and distressed is set forth in Rev. Rul. 70-585, as follows:

(1) provision of housing for low-income families relieves the poor and distressed;

(2) a determination of what constitutes poor and distressed is a factual question based on the surrounding circumstances; and

(3) participation in a federal or state program is not dispositive that the beneficiaries are poor and distressed.

The United States Housing Act of 1937, 42 U.S.C. 1437 et seq., has generally influenced the application of housing programs in the United States. Many programs administered pursuant to the Act use "low-income" as a qualification standard. "Low-income" under the Act has changed meaning over the years. When Rev. Rul. 70-585 was issued, "low-income" under the Act referred to the lowest income group that could not afford to cause private industry to build an adequate supply of safe, decent, and sanitary housing for that group. At that time, the Act did not use the term "very low-income." In a two-step process, Congress amended the Act. "Very low-income," defined as 50 percent of the area's median income was added. And "low-income" was redefined as 80 percent of the area's median income.

Because of the wide sphere of influence of the Act, it is natural that housing organizations qualifying for a program under the Act, would use the term "low-income" used under the Act to define the otherwise undefined term "low-income" used in Rev. Rul. 70-585. Housing organizations would argue that Rev. Rul. 70-585 concludes that the provision of housing for low-income families relieves the poor and distressed, and since "low-income" for housing purposes is generally defined in the U.S. housing programs as 80 percent of the area's median income, that same standard should apply to qualification for tax exemption. This immediately raises many problems regarding the application of Rev. Rul. 70-585.

First, the argument ignores the position that "low-income" must be defined by reference to all the surrounding facts and circumstances. Second, it ignores the position that qualification in a federal housing program is not determinative of qualification for exemption under IRC 501(c)(3). Third, it misunderstands that "low-income" as used in the Act in 1970 may have been consistent with the Service's use of the term in Rev. Rul. 70-585 but its current use is not consistent. Yet, housing organizations claim that an 80 percent standard may have been used for processing applications notwithstanding the Service's published position.

To clarify uncertainty, the announcement discusses facts and circumstances that may be used to demonstrate that an organization relieves the poor and

distressed.

B. Explanation of Facts and Circumstances

An organization may use facts and circumstances to demonstrate that the beneficiaries are poor and distressed as contemplated by Reg. 1.501(c)(3)-1(d)(2). It must also demonstrate that the organization relieves the poverty of the intended beneficiaries.

The first step requires a sufficient showing of charitable class beneficiaries. As demonstrated in factor (2) at Sec. 4.01 in the announcement, the closer an organization is to the safe harbor the less supporting factors will be required. Facts and circumstances may be used where an organization is unable to show sufficient levels of qualified residents. It is also available where other provisions of the safe harbor are not satisfied.

The announcement recognizes that the same levels of income groups as specified by the safe harbor percentages will not necessarily be present in a facts and circumstances approach. The facts and circumstances provide flexibility. For example, factor (1) at Sec. 4.01 in the announcement allows for a deficiency in the number of residents whose incomes do not exceed 80 percent of the area's median income provided there are increased levels of very low-income residents or residents whose incomes do not exceed 120 percent of the area's very low-income limits.

Factors (3) and (9) at Sec. 4.01 in the announcement address an affordability requirement. In essence, this pertains to whether an organization actually relieves poverty. Factor (3) requires rent restrictions on rental units. This is an extremely important factor. Example (5) at Sec. 4.01 in the announcement demonstrates that if poverty is not relieved then charity is not accomplished.

Factor (9) also recognizes that participation in a homeownership program requires special consideration because such programs generally serve residents with higher incomes than rental programs. Nonetheless, sales to the beneficiaries of the program must be affordable. As a rule of thumb, the cost of the house should ordinarily be low enough so that the debt service of the mortgage is about 35 percent of the intended beneficiary's income. Applications indicating debt service exceeding 40 percent of the buyer's income should provide compelling reasons explaining how the program is affordable.

Factor (4) at Sec. 4.01 in the announcement provides that operation in a government program is a supporting factor tending to demonstrate relief of persons in a charitable class. Consistent with Rev. Rul. 70-585, this factor, in and of itself, is not determinative of qualification.

Factor (5) at Sec. 4.01 in the announcement looks to the presence of a community-based board. It is a very important factor demonstrating that the organization is not operating for private interests. There is a lot of money available for housing operations provided through HUD funding, bond financing, low-income housing tax credits and a myriad of other agencies. Organizations that provide housing on a commercial basis are aware of these sources of funding for low-income housing. Commercial entities such as property managers, real estate developers, real estate investment funds, or tax credit investment funds will create nonprofit subsidiaries or affiliates to access alternative funding. To participate in the funding programs, the nonprofits are often required to be recognized as exempt under IRC 501(c)(3). Relationships of the organization's board to commercial organizations is always a relevant factor. The greater independence the board has in relation to commercial entities, the more convincing is its argument that it is not controlled by commercial affiliations. Generally, an appointment of a community-based board will help to demonstrate operation for a charitable rather than private purpose. Most convincing, are cases where a related commercial entity is removed from any control, whatsoever, to assure community-based control. In situations where strong relationships to commercial entities exist, approval of exemption may require at least a majority of board members to be answerable to other community interest organizations.

Factor (6), at Sec. 4.01 in the announcement, the provision of additional social services to the poor, factor (7), control by an existing housing organization exempt under IRC 501(c)(3), and factor (10), provision of affordability covenants that run with the property are not required of an organization to be recognized as charitable, but they indicate an altruistic intent on the part of the organization. They generally are not present in commercially oriented operations.

Finally, factor (8) at Sec. 4.01 in the announcement provides for a resident-by-resident approach in making a determination of whether a particular resident qualifies for treatment as a member of the benefited class of residents. This approach permits exceptions to assumptions regarding what income levels demonstrate "poor and distressed", but it requires regular monitoring to assure that a resident qualifies in spite of a higher income.

4. Other Charitable Purposes

A strong reaction to Notice 93-1 resulted from a concern that the notice preempted housing organizations from demonstrating that they carried out other charitable purposes described in Reg. 1.501(c)(3)-1(d)(2). This was never the intent behind Notice 93-1, which applied only to relief of the poor and distressed. The announcement clarifies that alternative charitable purposes listed in the regulation may be used by housing organizations. A housing organization does not have to demonstrate relief of the poor and distressed through the safe harbor or facts and circumstances. It may qualify for exemption as an organization that lessens the burdens of government, lessens neighborhood tensions, eliminates discrimination, combats community deterioration, or houses the elderly or handicapped. These charitable purposes are independent from relieving the poor and distressed. They provide separate bases for qualifying for exemption under IRC 501(c)(3). In addition to clarifying the availability of such charitable purpose, the announcement provides citations directing readers to additional statements of the Service's position. Expanded discussions of these charitable purposes are provided in the following part of this article.

A. Combatting Community Deterioration

Combatting community deterioration often applies to low-income housing organizations because many low-income housing projects are located in deteriorated areas, helping to relieve the problems of the depressed area. The importance of this approach is that the economic composition of the occupants of a low-income housing project does not have to meet the standards for relief of the poor and distressed. This should be of considerable interest to housing organizations which are funded from programs that permit economic mixes that are less restrictive than the safe harbor.

Generally, organizations seeking to qualify by combatting community deterioration are asked to supply information that the area in which they operate is designated by an appropriate governmental agency as blighted. An organization may be regarded as combatting community deterioration if it cleans up or rehabilitates existing structures, or constructs new buildings in this designated blighted area. While this approach is consistent with charity law, it is not the sole method of demonstrating that an organization combats community deterioration. Combatting community deterioration may be demonstrated by reference to all the surrounding facts and circumstances, not merely designation of blight.

Various revenue rulings address combatting community deterioration. These indicate that the Service is willing to conclude that an organization combats community deterioration without a designation from a governmental agency that the area is blighted, although, the designation adds a degree of comfort. For example, if an organization applies for an exemption involving a single project, and it can demonstrate that the area has indicia of deterioration, it may have little difficulty establishing that the area is deteriorated for purposes of combatting community deterioration. However, if an organization intends to engage in projects throughout the city or state that have not yet been identified, it would not be possible to conclude that the organization combats community deterioration without representations that the rehabilitation or construction activities will be confined to areas designated as blighted by an appropriate government agency.

Relevant factors that tend to demonstrate deterioration as well as potential deterioration may include:

(1) Income level of the area residents. Lower income levels are more frequently associated with the inability of the residents to maintain their residences. Closely associated is the portion of the residents below the poverty level.

(2) Age of the housing stock. This is particularly relevant when viewed in combination with the income level of the residents.

(3) Higher unemployment in the area relative to the surrounding areas indicates a generally poorer economic base.

(4) Location in relationship to parks or other areas for diversion. Limited recreational facilities place heavy pressures on the infrastructure of a neighborhood and may accelerate decline.

(5) Comparative housing cost. Declining housing costs helps identify an area in decline.

(6) Percentage of abandoned, boarded up or permanently vacant structures; the size and age of the structures and the length of time they have been boarded up.

(7) The amount of crime in an area as compared to the rest of the city.

(8) The level of drug trafficking.

(9) The presence and amount of graffiti.

(10) The percentage of homes below city code standards.

This list can be expanded. However, most areas that are in need of assistance have been designated as blighted or as an economic development zone by a governmental agency, or designated as eligible for some governmental subsidy.

Because the purpose for a designation may differ from agency to agency, a designation from one agency may, more effectively, demonstrate deterioration than a designation from another. If an organization does choose to use a designation of blight as a factor to demonstrate deterioration, it should be able to demonstrate that the basis for the designation demonstrates deterioration.

Although organizations combatting community deterioration generally operate in already deteriorated areas, these organizations may also operate in areas in the process of deteriorating to prevent further deterioration or in areas with a potential for deterioration to prevent future deterioration. Rev. Rul. 70-585, Situation 3, concludes that an area is already depressed based on studies that demonstrate that the area is old and badly deteriorated as well as having a lower median income than the rest of the city. In Rev. Rul. 68-17, 1968-1 C.B. 247, an organization is found to combat community deterioration by operating housing programs for low and moderate-income families in deteriorating neighborhoods. In Rev. Rul. 68-655, 1968-2 C.B. 213, the activities of the organization aimed at promoting racial integration, do not demonstrate actual deterioration of the neighborhood. In this ruling, the organization's activities that stabilize the neighborhood combat the potential for community deterioration.

In addition to establishing that it is operating in an area with actual, in process, or potential deterioration, an organization must demonstrate how it directly helps to relieve the problems related to the area's deterioration. It is not enough for this type of charitable organization to simply operate in a depressed area. Housing organizations must show that they specifically address problems

(such as providing better housing to existing area residents or low-income persons generally) which are related to actual, in process, or potential deterioration.

B. Lessening The Burdens Of Government

Because housing for all citizens is important to local, state, and federal government agencies, governments frequently are involved with nonprofit organizations operating within their boundaries that provide housing. The type and degree of government involvement may be sufficient to qualify an organization for exemption on the basis of lessening the burdens of government.

The test for lessening the burdens of government is generally provided in Rev. Ruls. 85-1 and 85-2, 1985-1 C.B. 178. These rulings set forth a two-part test to determine whether an organization lessens a burden of the government.

The first part of the lessening the burdens of government test is that the organization must demonstrate that its activities are actually burdens of the government. The Service has long held that the government is in the best position to determine whether the activity is its burden. Thus, the government must make an objective manifestation that, in effect, declares the activity to be its burden. The objective manifestation may be present in many forms and all facts and circumstances must be considered. Generally, the government manifests that certain activities are its burden if it is involved in the creation and control of the organization conducting the activities, or if it has conducted the activities in the past or is required to conduct them. More specifically, the following are examples of factors that have been used to establish that the government considers the activity to be its burden:

(1) Legislative creation of the organization intended to carry out the activity and a legislative definition of its structure and purposes.

(2) Legislative authorization for the creation of the type of organization intended to carry out the activity. This authorization, however, is not evidence of a government burden if the applicable statute considered in its entirety indicates that the activities were intended to be performed on a commercial basis by the private sector.

(3) Direct government involvement in and oversight of the

organization. This involvement and oversight may be seen in factors such as the government's appointment of all or several members of the board of directors, approval of the organization's bylaws, approval of or control over the organization's programs and expenditures, and review of the organization's records. Another sign of government involvement is the participation of government officials, acting in their official capacity, on the board of directors or in other decision-making capacities in the organization.

(4) Government funding of the organization's activities. This funding, however, is not the manifestation of a government burden if the government is providing public support for activities that are intended, by statute, to be carried out by the private sector or if the government is simply paying for goods and services that it contracted with the organization to provide.

(5) The organization participates with the government in conducting an activity that has actually been performed in the past by the government, acts jointly with the government in conducting an activity, conducts an activity that is an integral part of a larger government program, or takes over an existing government activity. There is evidence that the government considered an activity its burden if it engaged in this activity on a regular basis for a significant length of time, but not if the government previously engaged in the activity only infrequently.

(6) The activity performed by the organization is required by statute to be performed by the government or is acknowledged by legislation to be a government responsibility.

(7) The organization pays the government's obligations.

See generally G.C.M. 36225 (April 1, 1975), G.C.M. 38489 (August 29, 1980), G.C.M. 38693 (April 15, 1981), G.C.M. 39347 (October 20, 1982), G.C.M.

39682 (December 2, 1987), G.C.M. 39685 (December 10, 1987), G.C.M. 39733 (May 24, 1988), G.C.M. 39867 (December 18, 1991).

Notwithstanding the presence of any of these factors, the activity of the organization may not to be the government's burden if the government is prohibited by statute or constitution from participating in the specific activity carried out by the organization.

Another consideration is that the actual activity of the organization is the focus. Many governmental bodies have general purposes that are similar to those of an organization, but this does not create a governmental burden. This is particularly evident in the area of low-income housing where local, state and federal government agencies generally have housing statutes that authorize government function in easing the housing crises. Just because a statute may authorize governmental activity does not mean that the government would otherwise carry out an organization's precise activities. This holds even if the government participates in the same type of activity as the organization.

Mere endorsement by public officials of an organization's activities is not an objective manifestation by the government that it considers the activities to be its burden.

The second part of the lessening the burdens of government test is whether the organization actually lessens the burdens of the government. This is determined by reference to all the surrounding facts and circumstances. One factor frequently cited is a favorable working relationship. In such a situation it must be assumed that if the organization failed in carrying out its function to actually lessen the governmental burdens there would not be a favorable working relationship. A related factor is a continuing relationship. If the government continues to rely on the services of the organization, it must be assumed that the organization has in its prior activities actually lessened the governmental burdens. Although public endorsements do not demonstrate that the government considers an activity to be its burden, once a burden is established, it does suggest that the burden is lessened.

An area of concern is when the government contracts with an organization to carry out specified functions. If the government pays a contract price, the burden is not lessened. It has merely changed form. However, in Rev. Rul. 70-583, 1970-2 C.B. 114, an organization contracting with the government to operate correctional centers is considered to lessen the burdens of government because the

organization is supported, in part, by public contributions and foundation grants. Thus, it is able to provide the services at a reduced rate to the government, partially funding a government program.

Lessening of governmental burdens is the charitable purpose relied on by many banking consortia which provide home loans to under-served areas pursuant to the Community Reinvestment Act of 1977 (CRA), Pub. L. 95-128, 12 U.S.C. section 2901 et seq. Because these organizations have activities that are not generally carried out by governmental bodies, they are required to demonstrate the objective manifestation of the government by reference to the continuing government contact and control in the organizations' operations. Generally, the government is heavily involved in the planning for and the creation of the organization. In addition, government holds considerable control over selection of loan recipients. Further, reporting and government oversight assure that projects will be in government's interest.

C. Elimination Of Discrimination And Prejudice

A housing organization may qualify for exemption because it operates to eliminate discrimination and prejudice. Rev. Rul. 68-655, 1968-2 C.B. 213, holds that an organization operating to assist certain families purchase homes for the purpose of stabilizing an integrated neighborhood and to educate the public regarding integrated housing is charitable, in part, because it operates to eliminate discrimination and prejudice. In situation 2 of Rev. Rul. 70-585, an organization eliminates discrimination and prejudice by constructing new housing available for members of minority groups with low and moderate incomes who are unable to obtain adequate housing because of discrimination. In both rulings, the beneficiaries are not limited to lower income levels.

D. Lessening Neighborhood Tensions

Closely associated with combatting community deterioration and elimination of discrimination is lessening neighborhood tensions. It generally is used as a supporting purpose in connection with the poverty and community deterioration associated with over crowding in lower income areas in which minority ethnic or racial concentrations are high.

E. Housing For The Elderly

Although qualification for exemption for organizations providing housing

for the elderly once required the residents to be poor, the service has long held that the elderly experience their own unique form of distress and are members of a charitable class irrespective of their income levels. Thus, Rev. Rul 72-124, 1972-1 C.B. 145, which applies to a home for the aged and Rev. Rul. 79-18, 1979-1 C.B. 194, which applies to an organization providing specially designed and equipped rental units conclude that elimination of the unique forms of distress to which the elderly, as a class, are highly susceptible may be charitable even though financial assistance in the sense of relief of poverty may not be involved. These rulings set forth three needs that an organization must satisfy to qualify for exemption. These are the need for housing, the need for health care, and the need for financial security.

The need for housing may be satisfied if the housing is specially designed to meet some combination of physical, emotional, social, and religious needs of aged persons. This will generally be met where the construction includes features such as ramps, grab rails, switches and windows set at levels for persons in wheelchairs, emergency alarms, and areas for social and recreational pursuits.

The need for health care is satisfied if directly provided by the organization or by professional health care providers with which the organization maintains a continuing arrangement.

The need for financial security is met if two requirements are satisfied. First, the organization must demonstrate that it is committed to maintain in residence any persons who become unable to pay the regular charges. Sales to elderly residents which are subject to foreclosure do not satisfy the requirement of maintaining residents who become unable to pay. Second, the organization must demonstrate that it operates at the lowest feasible cost. The fees charged must be affordable for a significant segment of the elderly members of the community.

Both rulings discussed in this section present facts in which residency was limited to persons who were at least 65 years of age. G.C.M. 37101 (April 26, 1977) concluded that age 62 may also be an appropriate age limitation. While an exact age level has not been settled, organizations that place the admission requirement below 62 years of age would have to demonstrate that they are serving a class of persons that encounter special forms of distress based on their age.

Rev. Rul 79-19, 1979-1 C.B. 195, sets forth analogous requirements for persons who are handicapped.

5. Application of Announcement 95-37

Announcement 95-37, as of this writing, merely announces a proposed revenue procedure. But during an interim period prior to the revenue procedure's finalization, the announcement will provide guidance in the handling of applications. Therefore, applications for recognition of exemption may be processed by key District Offices if the announcement is satisfied. Until the announcement is finalized, adverse cases based on a failure to satisfy the announcement should be referred to Headquarters, Exempt Organizations Division, for processing.

Notice 93-1 is not considered to be an examination standard by the Service; rather, it is a set of criteria to screen cases for referral to Headquarters, as are other provisions of IRM 7664.31. In fact, the notice specifically states that it will not be applied to organizations that have ruling or determination letters. The existence of more liberal standards in the announcement should provide additional comfort that Notice 93-1 will not be used to disqualify existing exempt organizations.

A major concern rests on what application the finalized revenue procedure will have on examinations of organizations.

The finalized revenue procedure will provide a standard that assures an organization's exemption but it will not automatically revoke an existing letter. However, an organization may have to defend its exemption if examined. That is, if it fails the safe harbor and the facts and circumstances of the revenue procedure, it will have the burden to demonstrate that it is nevertheless charitable. The reliance rules of Rev. Proc. 95-4, 1995-1 I.R.B. 97, would also be applicable so that revocation would ordinarily not occur prior to written notification that the organization is no longer exempt.

6. Private Benefit Concerns

Announcement 95-37 states that in addition to demonstrating the accomplishment of a charitable purpose, an organization must also establish that it is not organized and operated to serve private interests.

An in-depth discussion of inurement and private benefit is beyond the scope of this article. However, forms of private benefit common to housing organizations bear mentioning. Most commonly, private benefit issues arise in the

context of closely controlled organizations. It may be as simple as the operation of an organization to provide employment or business opportunities to insiders. For example, a controlled organization may be used to obtain funds that pay brokerage commissions, development fees, rehabilitation fees, or property management fees that are, in turn, funnelled to the controlling individuals. On the other hand, the relationships may be complex and obscured by many layers of affiliations. Notwithstanding the degree of difficulty, the common thread is that the persons controlling the exempt organization transact business with that organization. Generally, these persons will be businessmen or professionals specializing in the development, financing, rental, or sales of real estate.

Sometimes exemption applications are submitted in which an applicant is set up and controlled by persons who also control a property management company. This fact pattern normally raises the level of concern because this is a common method for private persons to enrich themselves. However, these are very difficult issues to resolve because many sincere real estate professionals desire to use their expertise in the establishment of charitable programs. In either case, the organization may make one or more representations to demonstrate that the organization will not operate for the benefit of private persons.

First, an organization may represent that the property management fee will be at fair market value because the contract amount is approved by some federal or state housing agency. However, if the underlying purpose of the organization is to acquire management contracts for the interested directors, then the organization will have a more than insubstantial non-exempt purpose. The fact that the management may be provided at market rate or is approved by a governmental agency would not be determinative of whether private interests are served because the mere acquisition of the management contract would achieve the private purpose of the organization.

Second, an organization may represent that the selection of the management company will be made from bids submitted to the organization. However, a bidding process in which the interested directors will select the management contract would provide little assurance that private interests would not be served.

Third, an organization may represent that the interested directors will appoint an independent board representative of community interests. The Service has favorably accepted representations that an organization will appoint a disinterested community-based board of directors. If the organization is controlled by the persons that intend to acquire commissions, development contracts, or

management contracts, then mere representations should not assuage concerns with private benefit problems. Recognition of exemption ordinarily should await actual appointment of unrelated disinterested board members. Appointment of an attorney, accountant, or business associate(s) of the interested board member(s) should provide very little comfort. The most convincing case is the appointment of representatives of community development organizations involved in the development of charitable housing programs, so that the disinterested board members have an understanding of low-income housing development and management, a demonstrated interest in community improvement, and the power to approve the contracts of the organization. Nonetheless, operations that demonstrate that the interested directors still control the organization may negate the presence of a disinterested board.

Fourth, an organization may represent that it will not contract with insiders or their for-profit businesses. This representation may provide little assurance. If the board members originally set up an organization to funnel business to their management companies, then a representation that no transactions will be carried out with board members' businesses may sound hollow. Nevertheless, actually contracting with an unrelated management company supports the representation and will provide assurances.

Fifth, an organization may represent that services will be provided at a significant discount to the organization. When an organization contracts with interested board members, the circumstances may demonstrate that the organization does not have a purpose to benefit the insiders. Sales or services by the board members' businesses to an organization at a significant discount, at or below cost, would help to justify the selection based on the economic benefit to the organization.

The discussion has centered around management contracts, in part, because this is a common private benefit issue with housing organizations. However, there are many types of transactions in which housing organizations may serve private interests excessively that include sales or purchase of property, development contracts, construction contracts, maintenance contracts, real estate sales commissions, real estate financing and personal use of the property.

Transactions at fair market value with board members may be allowed. But the determination to do business with a board member or other interested party with control must be made by an independent disinterested board. It is not unusual for a board member to offer his own business services to the organization.

However, if the board member is not selected by a disinterested board, then a transaction that would provide services even at low market rates is problematic.

PART II - Limited Partnership Issues

"And Now For Something Completely Different"
Monty Python

1. Retrospective

In G.C.M. 36293 (May 30, 1975), which involved participation by an organization in a housing project, the Service concluded that an organization's participation as a general partner in a limited partnership is inherently incompatible with its exclusive operation for charitable purposes. The organization operated, in part, for the private financial interest of the limited partners.

However, G.C.M. 37852 (February 15, 1979) concluded that a partnership in which an exempt organization and a for-profit partner shared the expenses and the output of a blood fractionation laboratory would not create a conflict that would preclude exemption. Important to the conclusion was the fact that the partnership would operate on a break-even basis. Thus, because both partners operated through the partnership to produce and distribute fractionated blood at cost and shared equally in the output of the facility, there was no conflict in which the exempt organization would operate to produce profits for its partner.

At this time the Service position was that a partnership was not necessarily incompatible with the exemption of the exempt partner provided that the partnership arrangement could avoid conflicts. However, this conflicts approach would preclude exemption where the exempt organization was a general partner in a limited partnership because the fiduciary duty of the general partner to the limited partner investors is fraught with conflict.

The Service then lost two rounds in Plumstead Theatre Society, Inc v. Commissioner, 74 T.C. 1324 (1980), 675 F. 2d 244 (9th Cir. 1982), regarding an organization operated to produce theatrical plays. The court concluded that the organization's serving as general partner in a limited partnership was not inconsistent with exemption because the organization possessed the characteristics of a nonprofit theater rather than a for-profit theater. Importantly, the court reasoned that because (1) the limited partners had only an interest in a single play;

(2) the organization had no obligation to return the investor's capital from its own funds; and (3) the investors had no control over the operation of the exempt organization, it did not operate for the private interests of the limited partners.

Plumstead operated under the Uniform Limited Partnership Act ("ULPA"). Thus, when the courts concluded that a limited partnership arrangement did not violate a proscription against operating for private interests, it assumed certain characteristics common to limited partnerships generally. For example, limited partners (1) cannot manage the day-to-day affairs of the partnership, and (2) are liable for the debts of the partnership only to the extent of their investment. On the other hand, general partners manage the partnership and are liable jointly and severally for the debts of the partnership.

Following Plumstead, the Service initiated a two-step analysis in G.C.M. 39005 (June 28, 1983) to determine whether participation by an otherwise exempt organization in a partnership as a general partner adversely affects IRC 501(c)(3) qualification. First, whether participation by an organization in a partnership furthers its exempt purpose. Second, whether the partnership arrangement allows the organization to act exclusively in furtherance of an exempt purpose.

The second part of the test required an inquiry into the extent of insulation that the exempt general partner had in relation to its partnership obligations. See G.C.M. 39005 and 39444 (November 13, 1985). Subsequent G.C.M.s moved away from the insulation of the general partner analysis to whether the partnership arrangement causes the general partner to overly further the private interests of the investors. For example, G.C.M. 39546 (August 15, 1986) acknowledged that the tension between the fiduciary obligation to the limited partners and the exclusive operation in furtherance of exempt purposes may not be entirely eliminated through insulation. G.C.M. 39732 (May 19, 1988) did not consider insulation but, focused on the arrangement as allowing the organization to act exclusively to advance charitable purposes because (1) allocations of profits and losses were based on the respective partners' interest, and (2) items of income, deductions, or credits were not specially allocated in favor of any partner. G.C.M. 39862 (November 22, 1991) noted that in determining whether a partnership arrangement satisfies the second part of the test and allows the organization to act exclusively in furtherance of an exempt purpose, a requirement that the exempt general partner maintain a loss reserve to reduce the risk to the limited partners is a guarantee of investments outside the obligations a general partner owes to limited partners.

2. Application to Housing Partnerships

A. Participation

In considering whether participation by the organization in the partnership furthers its exempt purpose, the first step is to determine whether the organization is operated for exclusively charitable purposes through its control of the activities of the partnership. That is, would the activity qualify an organization for exemption under IRC 501(c)(3) if conducted directly by an otherwise qualified exempt organization? Accordingly, the exemption standards discussed in the first part of this article are relevant. And the partnership must satisfy these exemption standards since the exempt organization is, in effect, carrying out its purposes through the partnership.

B. Act Exclusively

In considering whether the partnership arrangement allows the organization to act exclusively in furtherance of exempt purposes, the principle that the limited partners should not overly benefit from their relationship to the exempt general partner raises particular concerns in the housing area.

While a housing venture which is allocated credits may yield some distributions, the primary component of the investment is the low-income housing tax credits under IRC 42. Accordingly, investors are careful to ensure that the partnership interests will be respected by the Service for federal tax purposes so that the credits will flow through to them in the intended proportions. This means that distributions in housing partnerships will usually reflect the economic interests of the partners. Unlike health care partnerships, any serving of private interests of the limited partners is unlikely to occur through disproportionate allocations in relation to capital contributions.

Nonetheless, transactions utilizing low-income housing tax credits may serve private interests. They provide good investments and attract institutional syndicators that set up investment funds to invest in tax credit projects. This type of syndication may occur prior to the selection of a project. So, these investment funds provide a ready source of funding for low-income housing organizations.

Since one purpose of an investment fund is to provide the most attractive investment for potential investors, an investment fund will gain a competitive advantage and attract investors by providing the most risk-free investment it can. Generally, low-income housing tax credit investments are arranged so that limited

partners will invest between 40 to 60 cents for each one dollar of credit. Investment funds have extremely strong bargaining positions. They have the money, so they dictate the terms. Institutional investors often draft their own partnership agreements to go with the money. Often the money and the terms are offered to prospective general partners on a take-it or leave-it basis. A primary focus of a partnership agreement is to ensure that the investors receive the anticipated tax credit. Further, agreements often attempt to ensure a return of the capital invested. To achieve these goals, problems generally arise in two areas. First, agreements will often place some level of control with the limited partners. Second, agreements will often carry guarantees on the receipt of tax credits and obligations to return capital investments.

3. The Issue of Control Over the Partnership

Control over an organization is often an issue of concern to the Service. While it does not, in and of itself, demonstrate excessive private benefit, it should necessarily raise a red flag. Certainly, control over the exempt organization by persons benefitting from the organization's operations suggests private benefit. See International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1-24-89); Wendy Parker Rehabilitation Foundation, TCM 1986-348; G.C.M. 39444 (November 13, 1985), and G.C.M. 39862 (November 22, 1991).

Where an organization seeks exemption through the operation of a partnership, the organization must necessarily demonstrate that it causes the partnership to carry out an exempt function, otherwise, there is precious little to support the organizations's exemption. There must exist some basis to consider that the charitable programs of the partnership are those of the exempt organization. Therefore, where an exempt organization carries out its exempt purpose through the operation of a partnership then the limited partners should not control the partnership. See Plumstead, Housing Pioneers, infra, and G.C.M. 39005 (June 28, 1983).

Limited partner control over the partnership may also suggest failure of an organization to be engaged in accomplishing an exempt function. In addition, it suggests the possibility of private benefit. In Plumstead, the court made a point that the limited partners did not intrude on the exempt operation of the organization. The court viewed the limited partners' participation as a very limited intrusion. Half of the play production was owned by another IRC 501(c)(3) organization. The limited partners owned two-thirds of Plumstead's interest, but they had virtually no control. This is, in part, due to the nature of the product.

Although the play constituted the organization's only activity, the investors had no rights in future productions. Because the president of Plumstead and star of the production was an internationally recognized star, the value of the production was dependent on his continued participation. Under these conditions, Plumstead maintained a significant amount of control over the production. Compare this to a situation in which an exempt organization operates a single housing project and is unlikely to be involved in others. Invariably, the situation will not create the natural elements of control retained by the general partner in Plumstead.

But what happens when an organization is not a controlling general partner? For example, the organization may be one of several general partners. If the organization does not have management control, control to enforce charitable operations, majority interest, or is not providing charitable services to the residents as its role in the operation of the partnership, then its qualification for exemption must be questioned.

4. Allowable Control Under ULPA

Because Plumstead found that operation of an exempt organization in a partnership operating under the ULPA was consistent with exemption, it is reasonable to conclude that inherent characteristics of limited partnerships under the ULPA are consistent with exemption. Under ULPAs, the day-to-day management of the partnership resides in the general partner. Yet, investors are able to exert considerable pressure on the general partner under partnership agreements that are fully consistent with limited partnership acts and that do not raise private benefit concerns.

An inherent principle of limited partnerships is that the general partner is personally liable for the debts of the partnership and that the limited partner is liable only to the extent of its investment. Therefore, a general partner may be required to make additional payments to cover operating deficits. Although this may indirectly benefit the limited partner, it is required of the general partner. Provided that the partnership is not under capitalized, operating deficits belonging to the general partner do not raise private benefit concerns.

However, partnership agreement provisions, even if otherwise allowed under the ULPA, may cause problems when tied to performance of the general partner which include obligations to return capital, or provide guarantees on the credits. For example, if an agreement provides that an operating deficit account funded by the general partner includes items that are not truly regarded as

operating deficits, then the funding of the account may be a hidden method of guaranteeing returns for the limited partner.

5. Problem Areas

A. Guarantees That May Defeat Exemption

Generally, the investments in a limited partnership are at risk. A guarantee by the general partner of the limited partners' investment demonstrates a private purpose contrary to operating exclusively for charitable purposes. Guarantees of a return on investments or a return of capital (as opposed to obligations by the general partner to cover the partnership's operating deficits) can occur in several ways. For example, a guarantee whereby the general partner is obligated to fund a loss reserve account from its assets in advance of any losses is problematic. Such an account should be established from the partnership's assets. Similarly, a guarantee by the general partner of the limited partners' capital investment should the partnership fail would result in excessive private benefit. Finally, a guarantee by the general partner of a return on investment would occur if the general partner obligates itself to provide for the tax credit benefits due the limited partners as opposed to an obligation to make all reasonable efforts to ensure that the partnership operates in such a manner as to qualify for tax credits.

But, problematic tax credit obligations may result from more subtle arrangements. The limited partner may be relieved of making scheduled capital contributions if the terms of the partnership agreement state that the general partner is unable to certify to receipt of all anticipated tax credits. Whether termed capital reduction amounts, credit adjustments, or some other similar term, these provisions are, in effect, arrangements to indemnify the limited partners by the general partner from a loss of capital or tax credits. Ordinarily, such provisions will provide that if the limited partner has already made all of its capital contributions then the general partner must make an out-of-pocket distribution to the limited partner.

B. Allowable Guarantees

Although guarantees should generally be viewed with suspicion, not all provisions that may partly guarantee a tax credit or promise a return of capital are necessarily bad. For example, guarantees payable solely from partnership assets may be permissible. In addition, a reasonable penalty for negligent operation on the part of the general partner for losses would not ordinarily raise private benefit

concerns. However, a penalty in which the general partner agrees to pay the tax credit amount, in affect, guarantees a return on the investment rather than merely covering damages.

Occasionally, investors will not mind that the general partner is a shell organization set up to protect a government housing authority or other exempt organization. It is unlikely that the organization can privately benefit the investor in spite of the language in the agreement where it has no assets at personal risk.

C. Captive Organizations

Another method of control involves a web of relationships in which other parties are related to the limited partner. For example, the agreement may reveal that the limited partner is related to a co-general partner, the developer, the property manager, and a special enforcement limited partner. There may even be a consultant to the general partner related to a limited partner. If any of these relationships are present, the limited partner or other party at interest may be driving the transaction, indicating possibly that the operation of the partnership may serve private interests. Again, the control must be linked to an excessive private benefit or to the absence of an exempt role by the general partner to affect the exemption.

6. Development of Applications Involving Partnerships

A. Development Questions

Because elements of limited partner control and benefits received as a result of that control can occur in so many ways, it is difficult to isolate the provisions that may cause difficulty. As discussed earlier, control coupled with an obligation to return capital or guarantee the tax credit demonstrate operations for the private benefit of the limited partner. However, partnership agreement provisions or operations that protect the investment of the limited partner may occur in a variety of ways. Sometimes, questionable provisions have a cumulative effect. The following questions may be useful in discerning unreasonable control and private benefit:

1. Does the limited partner have a right to amend the agreement?

   Ordinarily a limited partner may have the right to

approve amendments to the partnership agreement. This right protects its investment and will not allow the general partner to change the structure of the arrangement after the investment is made. However, the following sample of an actual agreement gives the limited partner an unqualified right to amend the agreement or dissolve the partnership:

> Notwithstanding any other provision herein the limited partner shall have the right to (1) amend this agreement in any particular and (2) dissolve the partnership.

This kind of provision indicates that the partnership could serve private interests since the agreement is subject to change or termination based solely on the needs of the limited partners.

2. Does the agreement provide for a special limited partner that may stand in for the exempt general partner?

   Special limited partners may act to enforce provisions of the agreement. Problems arise when the special limited partner is related to the investment limited partner and may step into the shoes of the general partner in a variety of situations. This generally increases the control that the limited partner has over the partnership. For example, the agreement referenced in (1) above provides that if the exempt general partner cannot make an operating advance then the special limited partner automatically becomes the managing general partner. Similarly, if the partnership receives an offer for the purchase of the project and the exempt general partner does not want to sell, then the special limited partner will become the managing general partner and will consummate the sale.

3. Has the exempt general partner granted a power of attorney to a limited partner to carry out the partnership business?

Coupled to the above discussion, the general partner may grant the limited partner a power of attorney to carry out certain transactions. Thus, if the general partner refuses to amend the agreement or sell the property the limited partner has that ability through a power of attorney. Again, limited partner control is greatly increased.

4. Does the special limited partner have management duties?

   This is a continuation of the above discussions. It should be noted that any time a limited partner can step into the shoes of the general partner, its control is greatly increased.

5. If sales of assets result in recognition of income by the limited partner, does the exempt general partner agree to pay the resulting tax liabilities?

   The point of this question is to focus on the purpose of the general partner. Covering tax liabilities is beyond the fiduciary obligations of the general partner. In effect, the provision guarantees the investment of the limited partner.

6. Does the agreement require the exempt general partner to maintain loss reserves for tax credit losses? Are these reserves funded from the general partner's assets?

   The limited partner invests in the limited partnership. The capital is at risk and it is uncertain that the limited partner will get a return on the investment. If the general partner guarantees out-of-pocket the amount of the anticipated tax credit, then it operates to remove the risk of the investor and demonstrates a noncharitable purpose to protect the investment.

7. If operating revenues are not available to cover loss reserves, must the exempt general partner fund the account?

A basic principle of limited partnerships is that the general partner operates the partnership to protect the investment of the limited partners. To the extent that the general partner operates so that the partnership maintains a loss reserve account out of partnership earnings, this should not provide an unusual benefit to the limited partners. However, if loss reserves must be made up out of the exempt general partner's assets, this may constitute a guarantee of return on the investment.

8. Does the agreement provide for payment of penalties and interest if the exempt general partner fails to perform in a timely manner?

   Whether such a provision may affect the exemption rests on the issue of reasonableness. If an exempt general partner operates the partnership negligently, it must expect to be penalized in some manner. However, one penalty provision reviewed that appears excessive on its face is a penalty of $500 a day plus interest on the penalty of prime plus three. This penalty was for failure to provide a balance sheet within a month and a half after the close of the year. Furthermore, the penalty would be due whether or not the limited partner suffered damages as a result in any delay in supplying the information.

9. Are there any provisions that would cause the automatic removal or withdrawal of the exempt general partner?

10. If so, may limited partners or an affiliate step into the management position?

    Automatic provisions such as this dilutes the general partner's control and adds to the limited partners' control. This is particularly true if the automatic removal is coupled with the rights of a special limited partner or power of attorney.

11. Does the limited partners' right to approve the sale of the

assets of the partnership act to give the limited partner sole discretion regarding the sale?

This provision gives the limited partner final authority over the partnership. If it can get an interested buyer to submit an offer, the limited partner can get out of the transaction any time presumably after the credit period without retaining the housing in low-income housing stock. This is directly contrary to the right of first refusal by the exempt general partner, which is viewed as a favorable factor in the organization's accomplishing an exempt purpose through participation in a limited partnership. A right of first refusal demonstrates a purpose to retain the housing for the poor.

12. Is the limited partner related to a co-general partner?

Any relationships that put the limited partner on both sides of the transaction operate to diffuse the control of the exempt general partner. Many times this relationship is merely the tip of the iceberg. If a transaction is in the nature an investor driven deal then an affiliate of the investor may also be the special limited partner, consultant to the general partner, developer, or property manager. These kinds of affiliations indicate a lack of control over the partnership and could affect the exemption.

13. If there is more than one general partner, does the nonexempt partner manage or otherwise control the partnership?

As stated earlier, if the exempt general partner has only a single partnership to carry out its exempt function, then it must be able to demonstrate sufficient control over the partnership to claim that the charitable functions carried out by the partnership are those of the general partner.

14. Is there an obligation to return capital to the limited partner?

Ever since Plumstead, return of capital has been viewed as beyond the scope of an exempt general partner's obligation to the limited partner. Typically, limited partners are liable only to the extent of their investment. But, the investment is at risk. Any provision in which the general partner obligates itself to return the capital investment of the limited partner from the personal assets of the general partner should be considered as operating for the private purpose of protecting the investment of the limited partner.

15. Has the timing of the offending provision passed without having been implemented?

    Often a provision in an agreement that would cause concern is no longer operative because the event has passed without requiring the exempt general partner to privately benefit an investor. In this situation, exemption may not be adversely affected, however, all the facts and circumstances should be considered to determine whether there is a pattern of abuse that needs to be corrected.

16. Does the exempt general partner have substantial assets of its own?

    Sometimes continued treatment as a partnership for federal tax purposes requires the general partner to maintain certain levels of assets to meet the personal liability of a partnership. If the exempt partner does have substantial assets, pay close attention to provisions in the agreement that may require payments from the personal assets of the exempt general partner directly to limited partners or indirectly as a payment to the partnership followed by a distribution to the limited partners, particularly if the payments constitute guarantees or return of capital.

17. What if the exempt general partner has no assets?

In some instances, a partnership is not required to maintain specified levels of assets to assure continued partnership treatment. In this situation, if a general partner can demonstrate that it is merely a shell to protect the assets of a housing authority or another organization exempt under IRC 501(c)(3), then provisions in the agreement in which the exempt partner guarantees credits or return of capital may not affect the general partner's exemption because it does not have the assets to privately benefit the investor, thus greatly decreasing the likelihood that the exempt general partner will excessively benefit the limited partners.

18. Will less than 100 percent of the units be qualified low-income under IRC 42?

    If all of the units of a project are occupied by persons regarded as poor and distressed then there may be limited opportunities for cash flow distributions to limited partners. Presence of market-rate apartments raises additional concerns regarding provisions governing distributions.

19. Will the project constitute a mixed-use project with commercial rentals? If so what portion is commercial?

    Sometimes low-income housing tax credits are used to finance only part of the project. If a project has a mixed use where there are substantial commercial rentals, there may be a substantial commercial purpose in the partnership's operation. This usually occurs in urban projects in which the entire ground floor is commercial. Depending on the amount of commercial units, mixed use does raise exemption and unrelated business income issues. These are factually specific situations.

20. Are any disproportionate or special distributions made to the limited partners?

> Partnerships utilizing low-income housing tax credits usually do not present a problem regarding distributions. They are generally careful to provide distributions in the percentage of the partners interest. Unlike health care partnerships, housing partnerships may have little income to distribute to the limited partners. Nonetheless, distributions to the limited partners that do not reflect their economic interests are problematic.

B. Applications For Exemption

If an organization intends to act as a general partner in a partnership that will apply for low-income housing tax credits under IRC 42, it will find itself in a situation in which the timing of events is critical. Such an organization will ordinarily apply for credits that have been set aside for use by qualified, nonprofit organizations. To be a qualified, nonprofit organization, an organization must be described in IRC 501(c)(3) or (4) and be exempt under IRC 501(a). While there may be some technical issue as to whether the mere filing of an application for exemption is sufficient, the practical consideration is that the allocating authority will require an organization to be recognized as exempt prior to its receiving an allocation of credits and an organization must have an allocation of credits prior to attracting investors.

The partnership arrangement must be scrutinized to assure that the exempt organization is not operating for private benefit as previously discussed in this article. Accordingly, the Service must usually be able to review the partnership agreement prior to recognizing exemption.

Exempt housing organizations that intend to finance through the syndication of low-income housing tax credits may find themselves in a "Catch-22". They cannot get exemption without the partnership agreement and they cannot get credits necessary for the partnership without the exemption. One approach used to solve this problem is through the use of initial partnership agreements. These agreements are used to establish the existence of a particular partnership so that an organization may apply for its certificate of limited partnership with the state, credit allocations or tax-exempt status.

Initial agreements may be identified by several indicators. The organization will generally be the initial limited partner as well as the general partner. The capital contribution of the initial limited partner will be nominal. The agreement

will provide for a replacement limited partner. And the initial agreement will be considerably shorter that the final agreement.

Such an agreement may set up the relationship among the general partners, if more than a single general partner is contemplated, however, it does not outline the relationship of the general partner to the investors. In fact, the initial agreement may have very little relationship to the appearance of the final agreement since the investment funds will supply their own agreement. Accordingly, scrutiny of an initial agreement will not allow the Service to determine whether the final partnership arrangement results in a private benefit to the investors. As stated in G.C.M. 39862 (November 22, 1991) involving hospital-related joint ventures, partnership arrangements that involve private taxable parties must be scrutinized for private inurement or more than incidental private benefit. The Service weighs all the facts and circumstances in each case, applying a "careful scrutiny" standard of review. The careful scrutiny applied under the G.C.M. would normally refer to the final agreement.

Furthermore, section 5 of Rev. Proc. 90-27, 1990 C.B. 515, provides that a ruling or determination letter will be issued to an organization, provided its application and supporting documents establish that it meets the particular requirements of the section under which exemption is claimed. Exempt status will be recognized in advance of operations if proposed operations can be described in sufficient detail to permit a conclusion that the organization will clearly meet the particular requirements of the section under which exemption is claimed. The organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures or other means adopted or planned for carrying out the activities. Where the organization cannot demonstrate to the satisfaction of the Service that its proposed activities will be exempt, a record of actual operations may be required before a ruling or determination letter will be issued.

When an organization submits an initial agreement, it acknowledges that it will enter into a limited partnership agreement. However, it will not be able to describe the particular relationship to the limited partners. Since such an evaluation is crucial to a determination of qualification, applications that cannot produce a final limited partnership agreement will ordinarily be deemed incomplete.

C. Foundation Classification

An often overlooked issue is the foundation classification of an exempt general partner in a housing partnership. The general partner may receive compensation or distributions from the partnership. Typically for purposes of foundation classification under IRC 509(a)(2), this support constitutes gross receipts in an activity which is not an unrelated trade or businesses. However, the support is subject to the $5,000 or 1 percent limitation from any single source. If the support received is in the form of compensation from the partnership for services rendered, the support would be regarded as coming from a single source and may cause the exempt general partner to be classified as a private foundation. Similarly, distributions of partnership earnings that retain their characterization as rents may be treated as gross receipts in an activity that is not unrelated trade or business. See Reg. 1.509(a)-3(m)(1). Whether such amounts may be treated as coming multiple sources for purposes of the $5,000 or 1 percent limitation is not clear. However, for purposes of determining acquisition indebtedness Reg. 1.514(c)-1(a)(2), Example (4) states that "[b]y reason of section 702(b) the character of any item realized by the partnership and included in the partner's distributive share shall be determined as if the partner realized such item directly from the source from which it was realized by the partnership and in the same manner."

Organizations that fail classification under IRC 509(a)(2) may, nevertheless, be classified as other than a private foundation. If an organization is created to operate a single project, it may be subordinate to a public charity and be classified as a supporting organization under IRC 509(a)(3). In other situations, an organization may receive contributions or grants in amounts to support a classification as a public charity under IRC 509(a)(1) and 170(b)(1)(A)(vi). However, many grants will be made directly to the partnership and should not be considered in making the foundation classification of the exempt general partner.

Although an exempt general partner may be classified as a private foundation, it may avoid chapter 42 taxes. Because the exempt general partner controls and carries out its exempt purpose through the partnership, the investment in and operation of the partnership would be regarded as a program related investment and functionally related business for purposes of excess business holdings under IRC 4943 or jeopardizing investments under IRC 4944. Further, an exempt general partner's investment in a housing limited partnership that accomplishes exempt purposes will not be treated as a taxable expenditure under IRC 4945(d)(5). See Reg. 53.4945-6(b)(1)(vi).

Partnership distributions to the general partner may be subject to tax under

IRC 4940. As a practical matter, an exempt general partner classified as a private foundation will ordinarily receive very little in partnership distribution since the exempt general partner usually holds only a 1 percent interest in the partnership and profits may not materialize. Also, an exempt general partner that is a private operating foundation may be able to reduce the two percent excise tax to one percent by meeting distribution requirements of IRC 4940(e)

Ordinarily, an exempt general partner should not have a problem with self dealing under IRC 4941. Limited partners are not disqualified persons with respect to the exempt general partner as a result of any capital contribution to the partnership. The capital contribution is made to the partnership and not to the exempt partner. Thus, a capital contribution to the partnership does not establish the limited partner as a disqualified person under any of the conditions set forth in IRC 4946(a)(1), defining disqualified persons. Moreover, the capital contribution made by the limited partners is an investment and not a "contribution" as that term is defined in Reg. 1.507-6(c)(1) and used in IRC 4946(a)(1). Thus, the limited partners would not be considered disqualified persons. partner unless they are otherwise described in IRC 4946.

7. Impact of Housing Pioneers

On March 29, 1993, the Tax Court filed a memorandum decision in the case of Housing Pioneers v. Commissioner, T.C.M. 1993-120,aff'd No. 93-70583 (9th Cir. March 7, 1995). Petitioners ("Pioneers") invoked Tax Court jurisdiction seeking a declaratory judgment on the Service's denial of exemption based on the fact that Pioneers was organized and operated for the private purpose of acquiring benefits for existing nonexempt housing organizations.

The facts indicate that Pioneers was formed to assist existing for-profit housing organizations acquire property tax exemption under state law and low-income housing tax credits under IRC 42. Pioneers entered into partnerships with existing for-profit organizations that owned nonexempt housing projects for the purpose of splitting the tax benefits with the for-profit partners. Pioneers had virtually no management responsibilities and could describe only a vague charitable function of surveying tenant needs. In effect, Pioneers sold its exempt status to for- profit organizations to enrich them and the founders of Pioneers. This was not a case where the exempt organization proposed a new housing program and sought out investors in limited partnerships to fund the charitable housing. Pioneers did nothing to increase low-income housing stock.

Furthermore, one of the housing organizations that would acquire tax benefits resulting from the Pioneer's operation was owned by the founders and managers of the Pioneers. It was not surprising that the Tax Court upheld the Service's denial of exemption under IRC 501(c)(3). However, the Tax Court did not stop with merely upholding the Service position. It appeared to go much further stating generally that it is difficult to see how Pioneers can avoid the nonexempt taint of providing tax credits under IRC 42 and property tax exemption provided under section 214(g) of the California Revenue and Taxation Code to nonexempt partners.

Pioneers appealed to the Ninth Circuit Court of Appeals. On appeal, the Service argued that Pioneers had no charitable objective based on the particular facts of the case. The Service argued normal private benefit and inurement rules rather than argue the Tax Court's conclusion that acquisition of tax credits is generally contrary to exemption. However, Pioneers argued that the Tax Court is incorrect because IRC 42 expressly contemplates participation of exempt organizations in partnerships acquiring low-income housing tax credits and that IRC 42 contemplates that exempt organizations will benefit noncharitable partnerships with the savings inuring to individuals. The court stated that the Pioneers argument is attractive, powerful and might well be successful if the Pioneers did not fail the material participation requirements under IRC 42(h)(5)(B).

The appellate court was aware that the Service ordinarily will recognize exemption of an organization which carries out its exempt function through the management of a limited partnership with for-profit partners if it is able to demonstrate that it operates exclusively for charitable purposes and only incidentally benefits private interests. The court did not acknowledge this long-standing approach. Instead it chose to discuss the possibility that IRC 42 modifies IRC 501(c)(3).

This appears unusual because the approach used by the court ignores Plumstead (also a 9th Circuit case) which has controlled the exemption of organizations operating as general partners for the last 15 years, and which would provide a basis for the court to conclude that Pioneers had a substantial nonexempt purpose. Rather, the court first concluded IRC 42 did not apply to Pioneers because Pioneers failed the material participation requirements under IRC 42(h)(5)(B). Then, the court stated that "[t]he usual rules for applying section 501(c)(3) apply," upholding the Tax Court's finding that Pioneers had a substantial non-exempt purpose. Accordingly, the application of Pioneers to an organization's

exempt status may be limited to the particular facts of the case. An organization acting as a general partner in a limited partnership utilizing low-income housing tax credits may still establish its exempt status under Plumstead, using the normal private benefit and inurement rules, rather than the material participation rules of IRC 42(h).

8. Conclusion

As the first part of the article demonstrates, much progress has been made in developing bright-line criteria. As Service employees, we are better equipped to make determinations or work examinations. Importantly, organizations understand the clear criteria, which leads to greater compliance. However, the second part of the article illustrates that housing is an area in flux. As sources of funding change, new problems and challenges will face the Service.